

# An Interpretive Analysis of how Audit Quality is Perceived in Economies in Transition

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**Abstract**—With the movement of many international accounting firms into Egypt, and the growth of local audit firms, it is particularly interesting, and relevant for governmental legislators, to study how the providers of the audit service perceive the quality of what they do. In this sense, the purpose of this paper is to report the perceptions of professional auditors in Egypt concerning how they perceive the quality of the service they provide. The paper also analyzes differences between perceptions of the Big 4 audit firms and other local audit firms. Based on 28 semi-structured interviews, it was revealed that the interviewees generally believed that the audit quality is preserved high in the presence of four factors: (1) high ethical standards to guide and regulate the profession; (2) a well planned and conducted audit; (3) a more knowledgeable audit team; and (4) having a good relationship with the client management.

**Index Terms**—Audit quality; Auditor independence; Closeness to client management; Egypt

## I. INTRODUCTION

With the increasing globalization of capital markets, there has been a growing recognition of the desirability of achieving uniformity and harmonization not only in the areas of financial reporting and auditing, but also in the ethical requirements that underpin the work of members of the accounting profession [1]. Key elements of the profession's ethical rules are those dealing with independence and the circumstances in which independence may be impaired.

Moreover, the recent spate of world-wide spectacular corporate collapses and frauds, such as Enron, WorldCom, Parmalat and many others, highlighted the need for enhanced corporate and regulatory governance [2]. Around the world and in the aftermath of these corporate collapses and frauds, and, in particular, the demise of Arthur Andersen, the adequacy of the auditor's legal requirements and professional standards for delivering a quality audit have come under increased scrutiny, in particular, the issue of auditor independence [3].

As a result to these recent scandals in the business environment auditing firms are now concentrating on the methods they apply in carrying out the audit process. One major incentive for this increased attention to the efficiency and effectiveness of the audit methodologies followed has been the increased questioning of the quality of the audit

process. This squeeze has led auditors to evaluate the design of the audit procedures applied with a view to enhancing the value provided to the client, the audited firm, and thus improving the audit's cost efficiency.

In this context, financial statement users are becoming aware of the existence of considerable conflict between the auditor and client management in the process of issuing the audit opinion. This conflict may eventually damage the credibility of audit firms and thus audit quality. If audit firms are to retain their important role in the financial reporting process, further research needs to be undertaken. However, most of the previous studies have been conducted in developed, Anglo-Saxon countries. Thus, there is much room for more research to be carried out in other countries, specifically in developing countries, to explore any cross-cultural similarities or differences that might exist; thus providing additional evidence on this issue in order to reduce the frequency of conflict in the audit context as well as how to manage this phenomenon in a constructive manner, which, in turn, could benefit all parties with a stake in ensuring auditor independence, even perhaps providing guidance to governmental legislators in refining their policies and standards on this matter.

In this sense, the main purpose of this paper is to report the perceptions of professional auditors in Egypt concerning how they perceive the quality of the service they provide. The paper also analyzes differences between perceptions of the Big 4 audit firms and other local audit firms. The remainder of this paper is organised as follows. Section 2 discusses the issue of audit quality. Section three explicates the factors that might impair auditor independence and are of interest in this study. Section 4 overviews the research design, followed by the results and their interpretation in section 5. The paper concludes by discussing some of the main findings, limitations of the research paper and paths for future research in section 6.

## II. AUDIT QUALITY

According to reference [4], audit quality depends on the ability of the auditor to carry out a thorough examination of the accounts and detect possible errors or anomalies (technical competence) and his or her willingness to provide an objective opinion on them (his or her independence). The term; i.e. audit quality, has become a concern after scandals such as Enron, WorldCom, and

Ahold, etc. These scandals raised concerns about audit quality even among the Big four accounting firms, which are normally considered the premier accounting firms and associated with higher audit quality. Among all these scandals, the Enron scandal attracted the greatest attention partly because it was associated with the collapse of Arthur Andersen. A significant outcome was in the USA where the Sarbanes-Oxley Act 2002 was enacted creating a tougher corporate governance and accountability regime, including a climate of stricter auditing independence rules. In other countries, government regulatory and professional bodies also followed suit with similar (proposed) changes to legislation and/or professional standards for the purpose of enhanced corporate governance, including audit quality [3].

As Reference [5] points out, audit quality can be conceptualized as a theoretical continuum ranging from very low to very high audit quality. On the lower end of the quality continuum audit failures obviously lies. Thus, audit quality is inversely related to audit failures: the higher the failure rate, the lower the quality of auditing. An audit failure occurs in two circumstances: when the auditor does not enforce the generally accepted accounting principles (GAAP failure); and when an auditor fails to issue a modified or qualified audit report in the appropriate circumstances (audit report failure). In both cases, the audited financial statements are potentially misleading to users.

Several studies have focussed on the construct. References [6]-[8] examined audit quality by reference to pricing differentials. Other studies (e.g., [9]-[12], among others) investigated audit quality differences among types of CPA firms and among individual firms using various surrogate measures of audit quality such as litigation against firms. Nonetheless, a major difficulty with determining the quality of the service provided by a given audit firm is that audit quality is not always directly observable, except in extreme cases such as litigation [13]. Litigation, however, is at best a rough (and usually inaccurate) indication of audit quality, which comprises several other dimensions. Accordingly, several other studies on the attributes of audit quality have been carried out. Reference [14] surveyed audit committee chairs and auditors to determine the effect of 15 factors on the quality of audits. They found that audit team factors (e.g., partner/manager involvement, independence of audit team members, etc.) were rated as more important than audit firm factors (e.g., quality control procedures and regulatory agency experience of the firm, etc.). However, they did not find any significant differences between audit committee chairs and auditors. Reference [15] surveyed financial statement preparers, users and auditors on 41 audit quality attributes. The most important factors were: experience with the client; industry expertise; responsiveness to client needs; and adherence to the general standards of GAAS (Generally Accepted Auditing Standards). Their study also found that team characteristics were rated as being more important than firm characteristics. Reference [16] investigated the relationship among client satisfaction, attributes of audit quality, auditor change, and controller work experience. They found a significant relationship

between many of the audit quality attributes previously identified in the literature and client satisfaction. Likewise, reference [14], in the US, found that auditor committee chairs rated audit team factors as more important than audit firm factors. Furthermore, reference [17], in the UK, surveyed the finance directors of 210 listed companies. Their findings show that the top five attributes were: integrity of firm; technical competence of firm; quality of working relationship with audit partner; good reputation; and technical competence of audit partner.

However, as highlighted by reference [13], audit quality is usually a subjective judgement made by clients and users. Consequently, it is critical for auditors to possess an understanding of what attributes clients and users perceive as being crucial to audit quality. Prior research has found that although auditors may believe that they are familiar with the criteria used by clients and users in evaluating audit quality, they do not accurately perceive their clients' expectations (see for e.g., [15]). For this reason, the perceptions of auditors, preparers, and users with respect to audit quality attributes warrant further examination. This is especially valid for clients and users belonging to cultural and institutional environments that are different from those in Anglo-Saxon countries.

### III. FACTORS IMPAIRING AUDITOR INDEPENDENCE

A related issue to audit quality is auditor independence, which is an imprecise and ambiguous concept, and there is much debate as to the appropriate level of auditor independence and how this should be achieved. As a result, regulators of financial reporting have debated over the past 35 years various conditions of the auditor-client relationship and audit profession that affect auditor's independence. Among these conditions are (1) the provision of non-audit services (NAS); (2) the level of competition in the auditing profession and the practice of lowballing; (3) length of auditor tenure and mandatory audit rotation; (4) size of the audit firm; and (5) Ambiguity of accounting rules. These conditions, it is argued, can potentially lower auditor's independence by lessening the objectivity of auditors in attestation roles who are expected to monitor opportunistic actions by managers. Regulators typically debate the degree to which (current or proposed) counterbalancing forces offset the potentially negative effects (cost, quality, and independence of audit services) of the auditor-client relationship. Such counterbalancing forces include legal sanctions imposed by courts/regulators, market penalties associated with the loss of auditors' reputation capital, limitations on non-audit services, and disclosures about the auditor-client relationship such as audit fee and non-audit fees.

Previous research that has been carried out to investigate the so many factors that might impair auditors' independence demonstrates mixed results. Hence, impairment to auditor independence is a question that needs to be investigated further as previous empirical studies on this topic yield mixed results.

This research paper explores the issue of concern, i.e.

audit quality, in the audit profession of Egypt. The paper aims to critically investigate how *audit quality* is perceived in Egypt. In so doing, it has been necessary to rely upon information furnished by responses to semi-structured interviews provided by Egyptian professional auditors. In particular, the semi-structured interviews are aimed at addressing the following research question:

**RQ: What are the main attributes that might maintain the quality of the audit, and how closeness to client management might affect auditors' independence?**

#### IV. RESEARCH DESIGN

The current research was based on conducting personal semi-structured interviews where an interview schedule has been prepared; however, the questions were left open-ended. The interview schedule was developed based on audit concepts selected from the literature and previous empirical studies. This interview schedule was refined following pilot interviews as follows. Four members of the academic staff at Cairo University, Egypt, who had adequate experience in auditing, in addition to three Egyptian Big 4 audit partners all agreed to participate in the pilot study. The final version of the interview schedule was sent to the interviewees in advance.

Starting in early July 2011 to early January 2012, a total of 28 semi-structured interviews were carried out in 8 different sized accounting firms. Agreement was obtained from the eight firms of accountants to participate in the study and interviews were conducted with 4 partners and 7 senior managers from two of the 'Big 4' accounting firms, 6 partners and 7 senior managers from 4 medium-sized firms of accountants, and, finally, 4 senior managers from 2 small-sized firms of accountants. The level of partners and managers was chosen because the results of the pilot study interviews indicated that if auditors were to choose a certain negotiation strategy during the audit process; this would be done by the partner or the manager.

The following section explores, in detail, the perceptions of the interviewees concerning the issues addressed above.

#### V. RESULTS OF INTERVIEW

##### A. Audit Quality

On the issue of audit quality, all the interviewees were asked what maintained the quality of the audit. In responding to this issue, the auditors, collectively, responded by saying that the most six important attributes were:

1. high ethical standards;
2. planning and conduct of the audit;
3. very knowledgeable audit team;
4. independence exhibited by audit team members;
5. protecting the reputation of the audit firm; and
6. frequent communication between the auditors and client management.

Based on this, the Egyptian auditors generally believed that the audit quality is preserved high whenever there are high ethical standards to guide and regulate the profession. Commenting on the quality of the audit work and ethical standards, a Big 4 audit partner commented:

***"The Syndicate has its own monitoring of standards, and, currently, most clients are rationally alert and they would decide if they are getting satisfactory service from their auditors or not, and if they are not then they would go to somebody else."***

Furthermore, with respect to the second attribute, i.e. planning and conduct of the audit; the interviewees believed that a well planned and conducted audit would, to a large extent, enhance audit quality. One non Big 4 audit partner admitted:

***"I never sign the audit report until I have reached the point where I am satisfied. And to be satisfied, I had to ensure that the whole audit process was well planned and was being conducted to my specifications."***

Coming to the third attribute, it can be concluded that the more knowledgeable the audit team, the higher the audit quality is. A non Big 4 senior manager commented:

***"We have a motto in our audit firm: Always know the company you are auditing, otherwise you are letting us [the entire audit firm] down."***

Related to this issue, some of the interviewees, when asked how to enhance the knowledge of the audit team, remarked that the most two crucial matters are keeping up-to-date with the modern audit techniques and attending any training courses run by the audit firm or by any other professional bodies.

The interviewees also pointed out that the most important characteristic of maintaining the audit quality is the independence exhibited by audit team members. One Big 4 audit partner commented:

***"Without independence, we [audit firm] lose the credibility and reputation of our firm, and, consequently, everything is ruined including the audit quality."***

Last but not least, the final characteristic expressed by the interviewees to enhance the quality of the audit work is good communication between the auditors and client management. Most of the interviewees admitted that having a good relationship with the clients would ease things for the two parties, i.e. the auditors and client management. Nevertheless, as remarked by a non Big 4 audit partner:

***"Although one of our [audit team] targets is building a good relationship with the client, we always avoid any clients who are likely to cause troubles and I, personally, remember resigning from one audit because the client was denying information from me."***

Moreover, the interviewees expressed a concern regarding the length of the auditor/client relationship, as one Big 4 senior manager remarked:

***"The longer the auditor/client relationship [more than five consecutive years], the less effective the audit is."***

Additionally, when the interviewees were asked to comment on some of the spectacular audit failures in the accountancy world of recent years, one common point of

view, among all interviewees, was growing commercial pressure and the lucrative non-audit fees the audit firms are offered nowadays.

Put all together, i.e., the results of this current study and other relevant previous studies, the findings indicate, when it comes to audit quality, the significant importance of the auditors' technical and competent skills, communication with client management, and reputation of audit firm.

#### *B. Factors Impairing Auditors' Independence*

The interviewees were asked about the nature of the relationship between the auditor and client management and how closeness to management might affect his/her independence. The interviewees expressed mixed experiences and contradictory attitudes to the issue and argued that such closeness would impair auditor's independence. Most of the audit partners and senior managers of the Big 4 audit firms did not support the idea of being too close to the client management. They believe that in order to conduct an independent audit, they should be sufficiently free from any influences, especially from management. Commenting on the auditors' independence and closeness to client management, an audit partner from one of the Big 4 commented:

***"We (audit partners) always remembered our staff not to be too close to client management as this will only cause troubles."***

On the other hand, the audit partners and senior managers in smaller (medium-sized and small-sized accounting firms) audit firm size supported the idea of closeness as this would, in their opinion, secure better co-operation from the management. A senior manager in one of the medium-sized audit firms admitted:

***"Being close to client management, we (audit team) were generally successful in gaining the necessary level of co-operation from the management to complete the audit to our specifications."***

Of more concern, when asked whether they ever come under pressure from client management, and that auditors might comply with accounting treatment preferred by client management when a difference of opinion on matters of accounting principles arises during an audit engagement, a majority of the interviewees expressed their concern for independence being impaired. In general, this attitude was due to the, relatively, small amount of audit fees as compared to non-audit fees, also severe competition in the audit profession was perceived as another threat. A senior manager in one of the medium-sized audit firms remarked:

***"Declining revenues [audit fees] is having a significant impact on auditors being less concerned with independence matters when it comes to accepting a client management's position."***

An almost common set of factors was indicated by the interviewees when they were asked to comment on or explain the factors that might affect auditors' ability to resist pressure from the client management. The factors indicated include: provision of non-audit services; the severe competition among audit firms; lengthy audit tenure;

ambiguity of accounting standards and the practice of opinion shopping; and size of audit firm. A discussion of each factor is given below.

#### *1) Provision of NAS*

The expression "non-audit services" is taken, for the purposes of this paper, to cover all services not coming within the scope of the audit contract that audit firms provide to their clients. It may include consulting services such as systems design, compliance-related services, such as taxation and accounting advice, and assurance-related services such as due diligence and internal audit.

When asked whether NAS strengthens or hinders auditors' independence, the interviewees showed no consensus; some believe NAS enhances the auditor's knowledge of the client, thus increasing the auditor's objectivity and independence, while others believe the provision of these services creates a working relationship between the auditor and the client that is too close.

A Big 4 audit partner explained his positive attitude towards the provision of NAS and auditors' independence by remarking:

***"In Egypt, as it is the case in most of the countries, the large [Big 4] audit firms dominate the market. And, given the large [Big 4] audit firms' greater reliance on NAS revenues, there may be a difference between large [Big 4] and other [non Big 4] audit firms with respect to their perceptions of how NAS influences auditors' independence. In addition, in our firm, we have separate staff members to perform the non audit services and this enhances independence."***

Another Big 4 senior manager added:

***"The provision of NAS increases the auditor's independence because these services enhance the auditor's "uniqueness" to the client. This distinctiveness increases the auditor's ability to maintain his/her independence."***

On the other hand, a non Big 4 senior manager asserted that the provision of NAS has a negative impact on auditors' independence because it makes the auditor unable to resist any pressure that might be exerted by client management. In her words, this senior manager said:

***"Part of the value of the audit process is dependent upon the auditor's [perceived] independence. And, in my opinion, [audit] firms providing NAS are [perceived] as having a higher risk of losing independence than those firms not providing such services."***

Nevertheless, another non Big 4 senior manager said:

***"Not all the NAS can impair auditors' independence, as there are some certain types that can impair it and others would not. For instance, if the service provided is not related to decision making, independence would not be an issue."***

#### *2) Severe Competition Among Audit Firms*

When asked about the level of competition in the profession, all the interviewees agreed that the auditing market in Egypt is becoming highly competitive due to the

large number of audit firms chasing a few large clients. The interviewees also expressed the opinion that such an environment may impair auditors' independence. Nonetheless, the reason for such a stance was mixed among the interviewees. For the non Big 4 firms, the audit partners and senior managers remarked that the main reason behind this impairment of independence is because of the threat of being switched by other auditors if they do not comply with their client's position. Whereas for the Big 4 firms, the interviewees commented, in general, by referring the main reason behind the impairment of independence to non Big 4 firms cutting down the audit fees to attract the clients, i.e. the practice of lowballing. This has led a Big 4 audit partner to express his dissatisfaction to such a practice by remarking:

***"The practice of cutting down fees [lowballing] to attract audit clients should be banned. This may be done via some sanction to be put in place to forbid other audit firms from such a conduct."***

On the contrary, a non Big 4 senior manager admitted:

***"To be honest with you, we [audit firm] are forced to cut down fees to attract new clients to compete in nowadays very severe competitive environment. Otherwise, we will not attract any new business nor keep the existing clients, and, thus, we will not be able to survive in the market."***

### 3) Lengthy Audit Tenure

When asked about the impact of lengthy audit tenure on auditors' independence, the interviewees' views on this issue were mixed. However, before offering a discussion of those views it should be noted that mandatory audit firm rotation has never been adopted in Egypt.

In general, none of the Big 4 auditors considered lengthy audit tenure as a threat to auditors' independence while some of the non Big 4 auditors perceived otherwise. All Big 4 auditors disagreed that lengthy audit tenure might impair their independence because they argue that they adhere to their ethical principles. This is evidenced by a Big 4 audit partner commenting:

***"Lengthy audit tenure familiarises the auditor with the client's business and thus makes him [her] on a position to objectively conduct the whole audit."***

Further, a Big 4 senior manager remarked:

***"The idea of rotation is not a good idea and it won't enhance auditors' independence. On the contrary, it may impair it because I believe clients may use it [rotation] as a way for switching auditors."***

Finally, a Big 4 audit partner commented:

***"From an economic perspective, rotation is irrelevant as it would include high costs of investment and higher audit risk and this would not add value to us [audit firm]."***

In contrast, non Big 4 auditors believe that lengthy audit tenure will affect independence resulting from the closeness to client management. In this sense, they agreed on having a policy for auditor rotation after a five year period. However, they expressed the concern of setting a period

less than this as it would only damage the audit firms, especially economically. This view is evidenced in the words of a non Big 4 senior manager who asserted:

***"The idea [auditor rotation] is very good because, in my opinion, it would preserve auditor's independence and would also keep up the quality of the audit work. However, in my opinion too, having the auditor rotated after a period of five years would be reasonable rather than a three year period in terms of gaining familiarity of the client's business which would decrease the time needed for the audit."***

### 4) Ambiguity of Accounting Standards and the Practice of Opinion Shopping

The interviewees were asked to elicit their opinion on whether ambiguity of accounting standards may either lead the auditor to impair his or her independence or may drive the client to search for another auditor who might give a more favourable opinion as compared to the incumbent auditor. Interestingly, all the Big 4 and non Big 4 auditors perceived ambiguity of accounting standards as a real threat to impairing their independence because the client may use this ambiguity to pressurize them. The following comments summarized auditors' views on this issue:

***"If we [the audit firm] cannot judge the materiality of a disputed item by referring to the appropriate [accounting] principles, the client is on a firmer ground than we are."*** Big 4 Audit Partner

***"If the accounting principles cannot help us [the audit firm] in judging a certain item, we always fear being subjective and thus, we are faced by one of two options; either to issue a clean report and here we face the threat of litigation; or to issue a qualified report, in which case arguments start with the client management and we might end up losing the client."*** Non Big 4 Senior Manager

### 5) Size of Audit Firm

When asked about the impact of audit firm size on auditors' independence, the interviewees' views on this issue were inconclusive. Big 4 auditors expressed the belief that audit firm size would not impair their independence because auditors are competent and qualified to carry out the audit regardless of size. The same view was elicited by audit partners and senior managers in medium sized firms. However, mixed views were elicited from auditors of small size firms. A senior manager of small audit firms expressed the belief that auditors of small audit firms are in a position to impair their independence when dealing with a large client as compared to any other clients. In contrast, two other senior managers of small sized audit firm did not believe that their independence would be impaired when they deal with large clients. The following comments summarize the views of Big 4 and non Big 4 auditors on this issue:

***"I do not believe that audit firm size may affect auditors' independence. The issue is about their [the auditors'] experience and relevant technical skills to handle the audit. You can expect audit failures in both, Big 4 and non Big 4 firms"*** A Big 4 audit

partner

***“In my opinion, this [small audit firm auditing a large client] should not be a threat as long as the audit firm is having the capacity to do it objectively”***

A Non Big 4 Senior Manager

***“As we all know, independence is the cornerstone of the profession. If in any case this concept is shaken, the audit loses its quality. In light of this, no I do not think that this case [small audit firms auditing large clients] would impair their independence”*** A Non Big 4 Senior Manager

## VI. CONCLUDING REMARKS

The findings reported here highlight the extra emphasis that previous research has attached to either the auditors' independence or to the general body of knowledge about accounting negotiation. The methodological position adopted in this study helped the researcher to be in a better position to illuminate and enlighten the issue under study. In the case of Egypt, to enhance auditors' independence and, consequently, the quality of the audit work, the researcher strongly supports the establishment of a proposed professional body in a new law to be authorised soon, to regulate the accounting and auditing profession in Egypt, that should enforce standards related to audit quality and ensure that sanctions are in place. Efforts are also needed for strengthening audit practice of auditors by providing training programs to auditors. Also, in the process of enhancing auditors' independence, the implication for the Egyptian auditing profession is that the proposed professional body may need to consider a move to restrict audit firms from rendering non-audit services or at least define, more specifically, non-audit services that can/cannot be rendered. It is likely that such action would not only diminish the frequency with which significant conflicts occur, but it would also probably strengthen the perceived ability of auditors to resist client management pressure. Also, it is strongly recommended that the proposed professional body should consider the length of the audit tenure and that mandatory auditor rotation after a period of 5 years should be required as a safeguard to ensure that auditor independence is preserved.

More efforts are needed for setting a “Code of Best Practice” for Corporate Governance in Egypt. The Cairo and Alexandria Stock Exchange very recent requirement for listed companies to form audit committees is a good step towards preserving, if not enhancing, auditors' independence but it will not be effective without full understanding, cooperation and support from the various parties involved, i.e. shareholders, internal auditors, and the Board of directors. The researcher believes that an audit committee that is in both appearance and fact independent of the management of the entity being audited and acts in the interests of investors should oversee the process of selection and appointment of the auditor and the conduct of the audit, thus enhancing auditor's independence..

Finally, as Egypt begins to move to become a market-based economy attracting the multinational Big audit firms to come and work in Egypt, the Egyptian government has

an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow the market to function effectively and to respond to expectations of shareholders and other stakeholders.

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